

No. 17,050

United States Court of Appeals
For the Ninth Circuit

BAY COUNTIES TITLE GUARANTY CO. (formerly Bay Counties Escrow Co.), vs. COMMISSIONER OF INTERNAL REVENUE, 	}	<i>Petitioner,</i> <i>Respondent.</i>
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PETITIONER'S REPLY BRIEF.

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vs.	
COMMISSIONER OF INTERNAL REVENUE, <i>Respondent.</i>	

PETITIONER'S REPLY BRIEF.

Respondent's brief displays the same fundamental lack of understanding of the nature of the expenditure in question as did the opinion of the Tax Court. However, the background of this case indicates that such lack of understanding is probably more feigned than real. As indicated by respondent (p. 8), this matter commenced as a result of an agent's determination that the expenditures in question were made in violation of California law and hence not deductible. After a trial primarily pointed by all parties to this issue, respondent recognized his error and abandoned the primary issue. However, in order to justify continuance of the case, the respondent made the same two arguments to the Tax Court as are here advanced. The second argument as will be later demonstrated was so clearly without merit that the Tax Court

did not even deign to discuss it. However, because of a lack of knowledge and understanding of the function of title companies in California the Tax Court fell into the error indicated, of treating the expenditures as capital.

We believe that viewed in the context of the title insurance business, the expenditures in question are clearly deductible.

Respondent and the Tax Court err in that (1) they assert that the reports are not used in the year of purchase and hence have a useful life in excess of one year; and (2) in that they use erroneous criteria in determining whether an expenditure is deductible or is capital in nature.

**I. THE REPORTS ARE USED IMMEDIATELY
IN PETITIONER'S BUSINESS.**

The nexus of respondent's argument in support of the Tax Court's determination is that "it is clear beyond any doubt that the starter reports have an economic life extending beyond the year of purchase and that they represented additions and supplements to the plant which increased its value." (Tr. 44; Brief p. 10.)

Such argument ignores the nature of petitioner's business and the use made of the starter reports. In the first place, petitioner, fundamentally, is in the business of providing a complete real property transfer service. The services rendered by California title companies are unique. In other states, these services are rendered by attorneys and title searchers who are agents of the parties.

Suppose we compare a typical transaction occurring in California with the same transaction in New York. Obviously, the buyer will not want to part with his money until he is assured that title will be vested in him free of all liens or all liens except those he is expressly willing to assume. The seller, on the other hand does not wish to part with the deed to his property until he receives the purchase price. In New York, the buyer consults his attorney who abstracts the title until he is satisfied as to the state of the title. He determines the documents necessary to eliminate any undesired lien. He examines the documents of transfer. After he is satisfied on behalf of his client, all parties with their attorneys meet together where the documents of transfer are executed and exchanged for the consideration. To fully protect the buyer, it is necessary to ascertain whether there are any lien creating documents filed up to the time of recording the deed. This takes another person at the recorder's office to examine the filings up to the time of transfer and to the time of recording.

In California, and specifically in San Francisco, on the other hand, all this is performed by the title company, both for the buyer and the seller. Usually the transaction goes one step further in that the title company *insures* the buyer that his title is as reported. In order to perform the services required by the buyer, including the issuance of a title insurance policy, the title company must be ready at all times to (1) report the state of any title in the City and County of San Francisco quickly and economically and (2) be in a position to insure that the title is as reported without exposing itself (or

its underwriters as in the case of petitioner) to undue risk of loss if the report proves defective. Therefore, petitioner and all title companies must have readily available *all* possible information concerning *any* parcel of real property in the City and County. To this end, petitioner makes heavy expenditures for title information to maintain its title plant in an up-to-date running order. Among such expenditures for information are those in question for starter reports. These are precisely the expenditures described (although not specifically identified) in O.D. 1018, 5 Cum. Bull. 119 (1921). Respondent and the Tax Court err when they state (Tr. 44-45; Brief p. 12) that petitioner "incurs the kind of expenses described in the cited ruling by its continuous subscription to Edward's Abstracts . . ." The error is in assuming that any *one* source is sufficient to provide the information needed to keep the title plant up to date.

Further, the error is made more apparent when it is clear that the same expenditure by the other title companies *has never been challenged by respondent* and is cited without comment in his brief (p. 4). Certainly, it cannot be argued that the cost of obtaining starter reports under the so-called reciprocal arrangement is different tax-wise from the cost of procuring such reports outside of that arrangement!

The limitation placed by respondent and the Tax Court on O.D. 1018 *supra* is unwarranted by the facts and the law. The cost of obtaining a copy of a deed or other document affecting Parcel A is clearly deductible under O.D. 1018 *supra*. However, neither petitioner nor any other title company may have a transaction affecting

Parcel A this year or next year or in fact within the lifetime of any of the people involved in this case. How then, can it be seriously argued that the cost of obtaining other title information concerning Parcel A is a capital expenditure *solely* because that information may not be used in the year the cost was incurred or in fact for many years thereafter? Certainly, it is clear that the expenditures described in O.D. 1018 do not in every case or even in most cases result in a “benefit derived from the payment [] realized and exhausted within the taxable year.” (Brief p. 11.)

Respondent’s analogy concerning an attorney’s books simply points out the error of his logic. (Brief pp. 12-13.) Petitioner during its early years purchased, set up or established the sets that are comparable to the set of United States Reports. *These were capitalized.* Now, however, in addition to the current volumes, petitioner purchases additional information in the form of briefs, copies of opinions, etc. concerning the cases currently appearing. Clearly, the purchase of such additional information, taxwise, is more like the purchase of the current volume than the purchase of the set.

Finally, respondent’s reliance upon *United States v. Times-Mirror Co.* (CA 9) 231 F. 2d 876, is misplaced. In that case, this Court sustained a determination that the micro-filming of its back issues during a war emergency was a deductible current expense. The *ratio-decendi* of that case is that such expenditures are deductible and that this Court could find no error in the District Court’s determination. To read into that case the principles asserted by respondent is completely unwarranted.

II. THE TAX COURT USED AN ERRONEOUS CRITERION.

It is readily apparent that the Tax Court in asserting that the expenditures in question were capital because the starters would not necessarily be used in a transaction in the year of acquisition was using the wrong criterion for determining the nature of the expenditure. In addition to the cases cited in our opening brief—all of which involved expenditures whose benefit was not exhausted in the taxable year, *United States v. Times-Mirror Co.*, *supra*, cited by respondent involved such an expenditure. The criterion used by the Tax Court in this case is expressly repudiated. So also in *Kansas City, etc. Ry. v. U. S.* (1953) 112 Fed. Supp. 165. In that case the railroad deducted the expense of driving poles in its road bed to correct the effect of water pockets. The poles when so used, solved the problem for many years. The Court of Claims in rejecting the argument that these were capital expenditures said:

“ . . . The fact that the replacements, once made, would be good for many years, would not seem to be significant. When a building or a machine is repaired, it is not unusual that the repaired portion is better than and will outlast the parts that have not yet needed repairs.”

III. THE SECOND PRINCIPAL ARGUMENT MADE BY RESPONDENT IS CLEARLY WITHOUT MERIT.

It is uncontradicted that during the years prior to January 1, 1952, petitioner, for reasons of its own, capitalized all expenses connected with its title plant. Many of these expenses included salaries and office supplies that are without doubt current expenses. Whether all these expenditures were currently deductible or not is not before this Court. However, it is *not* a change of accounting method to claim as a deduction from gross income that which has always been deductible but which the taxpayer did not claim in prior years. If this were so, taxpayers could *never* seek refunds for erroneously having treated deductible items as not deductible. Taxpayers would always be met with the argument that their election of this "method of accounting" could not be changed without consent. Certainly to state the argument advanced by respondent is to show its absurdity.

So far as the reported cases indicate, it has never been claimed that a taxpayer was barred from claiming a deduction because in prior years he treated it as a non-deductible capital item rather than claiming the deduction. The Commissioner did contend in *Beacon Publishing Co. v. Commissioner* (1955) 218 F. 2d 697, 55-1 USTC, Par. 9134, that when an accrual basis taxpayer deferred pre-paid subscriptions until the year in which the income was earned it was changing its accounting method. However, the Court of Appeals said:

"The taxpayer, however, did not seek to change its accounting system. It did no more than apply the method adopted and in use to clearly reflect its income.

This the taxpayer had the right to do and the Commissioner had the right to require it. *United States v. American Can Co.*, supra. A discretion of the Commissioner does not empower him to add to the taxpayer's gross income for a given year, an item which rightfully belongs in another year. *Commissioner v. Frame*, 8 Cir., 195 Fed. (2d) 166 [52-1 USTC, Par. 9239]; *Commissioner v. Mnookin's Estate*, 8 Cir., 184 Fed. (2d) 89 [50-2 USTC, Par. 9431].

“We have no doubt that the taxpayer could not change its method of keeping books without the consent of the Commissioner, even as to items, if the change resulted in an avoidance of the payment of taxes due, *nor do we have any doubt but that a taxpayer may, without the consent of the Commissioner, apply the method of accounting which he has adopted, though not theretofore applied to a particular item, when that change will correct errors and clearly reflect his income.* We think the change in this case falls within the latter category.” (Emphasis added.)

We do not contest the validity of the cited regulation or statute, only the application thereof to this case. An illustration will serve to point out the proper application of the cited regulation and statute: If a taxpayer had not in prior years deducted *any* depreciation, it would *not* be a change of bookkeeping within the meaning of the regulation or the statute to deduct depreciation in this taxable year. However, if in the past the taxpayer had used the straight line method of computing depreciation a change of the method of computation would be a change of bookkeeping within the statute and regulation.

CONCLUSION.

The Tax Court's disallowance of the deduction was based upon a misconception of the facts and the use of the wrong criterion. Respondent has not advanced any arguments justifying the affirmance of the Tax Court, other than those used by that Court. The decision of the Tax Court should be reversed.

Respectfully submitted,

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